BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
HUBERT J. AND LEONE E. TAYLOR)

For Appellants: Peter J. DiGrazia
Attorney at Law

For Respondent: Claudia K. Land
Counsel

O P I N I O N

This appeal is made pursuant to section 18593 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Hubert J. and Leone E. Taylor against proposed assessments of additional personal income tax in the amounts of $1,972.32 and $117.49 for the years 1975 and 1976, respectively.

Appeal of Hubert J. and Leone E. Taylor

The sole issue for determination is whether a $25,000 loss sustained by appellants in 1975 was properly characterized as a'capital loss.

Prior to 1974 appellant Hubert J. Taylor had retired from the military and was unemployed. In April of that year, appellant advanced $25,000 to Data Enterprises, Inc. in exchange for 10 percent of the common stock to be issued at a later date and an option to purchase an additional 20 percent of the shares. Data intended to manufacture a new gas saving device for automobiles. Appellant became vice president of Data and worked for the company'from April through October of 1974. Appellant received no salary, however, because' of the weak- financial condition of the company. On -September 10, 1974, appellant-resigned as vice president since other business commitments prevented him from carrying out his duties as an officer. On November 3, 1974, appellant began full time salaried employment as an advance systems manager with Interstate Electronics Corporation. In November 1975, Data ceased-to' do business because of financial difficulties. All assets of the business were used to satisfy the corporation's creditors. No stock was ever issued, and appellant did not recover any portion of his $25,000 investment.

On their 1975 personal income tax return,. appellants deducted the entire $25,000 loss as a business bad debt. Respondent recharacterized the. loss as a nonbusiness bad debt subject to the $1,000 capital loss limitation (Rev. & Tax. Code, § 18152), and issued the proposed assessment in issue.. Respondent then recalculated appellants' 1976 liability-by allowing a $1,000 capital loss carryover, but disallowing the use of income averaging since appellants' revised 1975 income rendered them ineligible to income average.

In support of his position that the loss was an ordinary one and not a capital loss, appellant makes two arguments. First, appellant maintains that, 'in view of his age upon retirement from military service, obtaining employment was expected to be difficult. Therefore, appellant contends, the loss was a- business bad debt since his interest in the business was- purchased in order to secure employment-.- Secondly, appellant argues that the stock to be issued should be characterized as "small business corporation stock," the loss from which is deductible as an ordinary loss up to a statutory minimum[1/]. (See Rev. & Tax. Code, §§ 18206-18210.)

When a taxpayer makes an advance to a corporation which subsequently becomes insolvent, the transaction may be treated in three different ways, depending upon the character of the advance and the dominant motive of the taxpayer in making it.. If the advance is a contribution to capital and it becomes worthless, the shareholder is entitled to a capital loss, subject. to statutory limitations. If the advance is a genuine debt which becomes worthless, it may be either a nonbusiness bad debt which is treated as a short- term capital loss, or a business bad debt which is treated as an ordinary loss and may be deducted in full against ordinary income. (Raymond v. United States, 511 F.2d 185, 189 (6th" Cir. 1975).) One of the ways to establish that a loss was created or acquired in connection with the taxpayer's trade or business and entitled to ordinary loss treatment is to show that the dominant motive in making-the loan was to protect his employment. (United States v. Generes, 405 U.S. 93 [31 L. Ed, 2d 62] (1972): Putoma Corp., 66 T.C. 652, 674 (1976).) However, in order to prevail on this theory, the taxpayer must first establish that the advance was a loan and not a capital contribution. If it is determined that the advance was a contribution to capital, it is no longer necessary to determine whether the advance could be characterized as a business or a nonbusiness debt. (Raymond v. United States, supra.)

The most obvious requirement for the deduction of a bad debt is the existence of a valid debt. A bona fide debt is one which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money. (Cal. Admin. Code, tit. 18, reg. 17207, subd. (a)(3).) In this matter, appellant contracted to, and did, advance $25,000 to Data in exchange for 10 percent of the stock which was to be issued at a later date and an option to

1/ Presumably, it is appellants' unexpressed intent that these arguments be made in the alternative since it is inconsistent to argue that an advance to a closely held corporation is a debt on one hand, and a contribution to capital on the other.

purchase an additional 20 percent of the stock..' The burden of provinq that a valid debt existed is upon appellant.- (Appeal of Cecil W. Harris, Cal. St. Bd. of Equal., Jan. 6, 1977.) Since appellant has failed to offer any evidence tending'to establish that the transaction in question created a debtor-creditor relationship, we must conclude that this transaction constituted a contribution to capital and not the creation of a valid debt. (Appeal of Cecil W. Harris, supra; Appeal of Dudley A.-and.Sherrill M. Smith, Cal. St. Rd. of Equal., Dec. 15,1976.)

Even ifwe wereto conclude that the $25,000 advanced to the corporation was a bona fide debt, as respondent apparently did,-appellant still could not prevail. We are not convinced that appellant's dominant motive for making the investment was to secure employment. The only evidence supporting appellant'sclaim is his statement that, in view of his age upon retirement from the military, his interest in securing future employment was the dominant- motive for making the investment. In view of appellant's military pension, coupled with his ability to obtain permanent salaried employment within a few weeks after terminating his association with the corporation, it is highly unlikely that potential future employment was the dominating factor behind appellant's $25,000 investment in Data. Moreover, the fact that appellant received no salary from Data reduces the likelihood that continued employment was the dominant motivation behind the investment. As the Tax Court said in Putoma Corp., supra:

> While [taxpayer] might have had the expectation of future salary payments, a loan motivated by one's status as an employee seems more plausible where its objective is to protect a present salary, rather than promote a future one. Putting funds at risk under such circumstances is more characteristic of the investor. (66 T.C. at 674, footnote omitted.)

Appellant also argues that the stock to be issued should be characterized as "small business corporation stock," the loss. from which is deductible as an ordinary loss. This argument must. also be rejected..

The loss from "small business corporation stock" may be deductible as an ordinary loss up _-to a statutory maximum. (See-generally; Rev. & Tax. Code;'-

§§ 18206-18210; Cal. Admin. Code, tit. 18, regs. 18206-18210 (a)-(h).) Sections 18206 through 18210 of the Revenue and Taxation Code are substantially identical to section 1244 of the Internal Revenue Code of 1954. Section 1244 was enacted to encourage the financing of "small business corporations" by providing for beneficial income tax treatment in case of a loss on stock investments in qualified corporations. (See generaliv, Anderson v. United States, 436 F.2d 356 (10th Cir. 1971).) '"Small business corporation stock" may be defined as-common stock issued for money or other property by a domestic "small business corporation" under a plan adopted to offer such stock for a period specified in the plan, ending not later than two years after the date the plan was adopted.

Disregarding the fact that no-stock was ever. issued, appellant's argument must fail because 'there was no written plan. (Rev. & Tax. Code, § 18208; Cal. Admin. Code, tit. 18, reg. 18206-18210(c).) It is true that -certain corporate writings, such as minutes, resolutions, applications and permits to issue, may constitute a written plan if they embody all of the elements required by the statutes and regulations. (See, e.g., Eger v. Commissioner, 393 F.2d 243 (2nd Cir. 1968); Appeal of Robert W. and Margaret H. Rector, Cal. St. Bd. of Equal., June 3, 1975.) However, in this matter there simply was no formal written plan or any other corporate documents which could suffice.

For-the reasons set forth above, it is our conclusion that respondent's action in this matter must be sustained.

Appeal of Hubert J. and Leone E. Taylor

O R D E R

Pursuant to the views expressed in the opinion'. of the board on file in this proceeding,-and good cause.. appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation-Code, that'the action of the Franchise Tax Board on the protest of Hubert J. and Leone E. Taylor against 'proposed assessments of additional personal income tax in the amounts of $1,972.32 and $117.49 for the years 1975 and 1976, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 18th day of August , 1980, by the State Board of Equalization.

____________________, Chairman

____________________, Member

____________________, Member

____________________, Member

____________________, Member